VZCZCXRO5646
RR RUEHAST RUEHBI RUEHCI RUEHLH RUEHNEH RUEHPW
DE RUEHNE #2962/01 3251229
ZNR UUUUU ZZH
R 201229Z NOV 08
FM AMEMBASSY NEW DELHI
TO RUEHC/SECSTATE WASHDC 4287
INFO RUCNCLS/ALL SOUTH AND CENTRAL ASIA COLLECTIVE
RUEHGV/USMISSION GENEVA 7959
RUCPDOC/DEPT OF COMMERCE WASHDC
RHEBAAA/DEPT OF ENERGY WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
RULSDMK/DEPT OF TRANSPORTATION WASHDC
RHMFIUU/FAA NATIONAL HQ WASHINGTON DC
RUEHRC/DEPT OF AGRICULTURE WASHDC

UNCLAS SECTION 01 OF 03 NEW DELHI 002962

SENSITIVE
SIPDIS

STATE FOR SCA/INS AND EEB
USDOC FOR ITA/MAC/OSA/LDROKER/ASTERN/KRUDD
DEPT PASS TO USTR MDELANEY/CLILIENFELD/AADLER
DEPT PASS TO TREASURY FOR OFFICE OF SOUTH ASIA MNUGENT
TREASURY PASS TO FRB SAN FRANCISCO/TERESA CURRAN

E.O. 12958: N/A
TAGS: EAGR ECON EFIN EINV ETRD IN
SUBJECT: MUMBAI ASSESSES THE MARKETS, EXPECTS MORE RBI MOVES

¶1. (SBU) Summary. In meetings in Mumbai on November 14-15, Mumbai financial and market analysts shared their views on liquidity conditions and their expectations for further monetary actions with Econoffs from New Delhi and Mumbai. They also conveyed a "wait and see" approach to re-entering India's debt and capital markets, pointing to political uncertainties stemming from ongoing state elections and imminent national elections, as well as global financial and economic uncertainties. End summary.

STILL A LACK OF LIQUIDITY?

¶2. (SBU) Most market participants agree that the Reserve Bank of India (RBI) has moved relatively quickly to shore up liquidity in the system since mid-September, when some interbank lending rates shot up to more than 20%. However, Ridham Desai, Managing Director, Morgan Stanley, asserted that there was still a liquidity, as opposed to a confidence, problem. He linked it to declining net capital inflows, which are putting downward pressure on the rupee. Because of the speed of the weakening rupee, the RBI has been intervening in the forex markets to prop up the rupee by the sale of dollars. Those sales take rupees out of the system, thus counteracting the central bank's efforts to enhance liquidity.

¶3. (SBU) Desai described a drastic reduction in trade credit in October, as well as potential drops in worker remittances and Non-Resident India (NRI) fixed deposits as other possible weaknesses in India's balance of payments in the months ahead. He estimated that, at $14 billion so far this year, non-foreign institutional investor (FII) outflows, especially trade credit, have been higher than FII outflows of roughly $11 billion, which have been the main focus for explaining the weakening rupee. (Comment: Since FII outflows have been rather steady through 2008 and did not noticeably spike in September-October, when the rupee dropped the most, non-FII, especially trade finance-related outflows are likely an important part of the picture. End comment.) These reduced inflows would continue to put pressure on the rupee, Desai expected, and thus prolong RBI currency intervention at the cost of enhanced liquidity.

¶4. (SBU) While not disputing Desai's assertion that India's markets lack liquidity, JP Morgan's Ritu Kocchar and Ashvin Parekh of Ernst and Young pointed to a few changes that have eased domestic pressure on liquidity and, to some degree, on the rupee. They noted that money market redemptions - which surged in September and October as Indian global companies tapped their cash reserves to help finance their domestic working capital as well as their overseas

subsidiaries denied dollar financing -- have eased considerably, in light of several recent RBI facilities and possible improvements in short-term financing abroad. Others also pointed to the government's issuance of new oil bonds to the state-owned oil marketing companies (OMCs).

¶5. (SBU) The RBI is currently accepting the oil bonds directly from the OMCs in exchange for hard currency to the OMCs to finance their imports. OMCs had been borrowing large amounts in the domestic markets to cover the losses they were incurring because of government controls on domestic energy prices. The OMCs' borrowing (and dollar) needs have dropped drastically with the oil bonds and RBI exchange facility. (Comment: Soon the need for oil bonds and exchange facilities will also drop drastically as the OMCs' oil price contracts roll over to represent current spot prices at less than half of July's peak. End comment.)

¶6. (SBU) In contrast, Vivek Kudva, President, Franklin Templeton Asset Management India, stated that banks were unwilling to lend, independent of liquidity, because the banks fear a recessionary impact on corporate business. Commercial banks are also imposing high costs on letters of credit and trade finance right now as well, he said. Kocchar agreed that bank sentiment was low and thought that a reduction in interest rates would boost banks' confidence in corporate borrowers' ability to service their loans.

WHAT CAN THE RBI STILL DO?

¶7. (SBU) Even in the wake of the RBI's significant efforts to enhance liquidity since September, including a 150 basis point

reduction in the benchmark lending rate and a 300 basis point reduction in the cash reserve ratio (CRR), interlocutors thought there was still more that could be done. Kocchar singled out the CRR as the most effective tool available to the RBI, since it immediately affects liquidity in the system. She easily expected the CRR, now at 5.5%, could go below 3%. Kocchar cited the RBI as having said there is no floor to the CRR. While she has heard predictions of a rate reduction in January and April (in the run-up to national elections), Kocchar also thinks the RBI could reduce the CRR by 50 basis points as early as this month, while state elections are underway. Morgan Stanley's Desai thought the CRR could be lowered to zero, which he calculated would release more than $40 billion in liquidity.

¶8. (SBU) Kocchar also anticipated more interest rate reductions through the repo rate, the rate at which the central bank lends to other banks. She anticipated that could help improve sentiment in the financial system. Sentiment still needs a boost, she claimed, because lending has not really revived, even as the RBI has enacted near weekly liquidity enhancements totaling more than $25 billion. Kocchar pointed to the government's borrowing program (which crowds out liquidity to the private sector) as well as continued market uncertainties as leading to lending volatility, exacerbated by banks' wish to reduce assets to increase safety and security.

EXPECTATIONS OF INCREASED PRESSURE ON CORPORATE LOANS
--- -----

¶9. (SBU) In addition to improving sentiment, Kocchar thought that lower rates would ease pressure on retail loans, as consumers' cost of financing would go down. In contrast, Kocchar expected lending to small and medium enterprises (SMEs) to be hardhit, as corporate loans to this segment will be stressed by the SMEs' decreased ability to service their loans amidst a business cycle downturn. Others also pointed to a weakness in corporate loans. Morgan Stanley's Desai remarked that a number of Indian companies, including a few large ones, will have to restructure their loan portfolios. While Indian companies are relatively underleveraged financially, Desai argued that many of them had significantly increased their operating costs in recent years, by expanding production and payrolls. As India's economy slows as a fallout of the global financial crisis and downturn in global demand, the decline in revenues will make it harder to support operating costs.

He expects this period to last about a year and a half, before the Indian economy picks up. (Comment: Unlike American firms, Indian firms will be reluctant to lay off workers as a cost-cutting strategy, and will instead turn to banks for restructuring their loans, and to the government for assistance on duties, tariffs, or price support measures. End comment.)

¶10. (SBU) Ernst and Young's Ashvin Parekh estimated that banking non-performing loans (NPLs) had risen from a recent low of $9 billion to around $20 billion, although still a small percentage of total banking assets at roughly 3.5 percent. He also expected that some major corporates as well as SMEs might need to restructure loans, since both primary and secondary equity markets had dried up in recent months, foreclosing that route for big companies. Parekh attributed it to instances of overexpansion, like Desai.

CURRENT POLITICAL ECONOMY PROMOTES WAIT AND SEE

¶11. (SBU) DK Joshi, Principal Economist, CRISIL, stated that he was waiting for the 2008 annual reports of US companies in order to gain a "true picture" of the US economy and hence its impact on India's economy. Ashvin Parekh of Ernst and Young characterized Indian markets as being in a holding pattern, pointing to industrial production, corporate results, and inflation data in January as major signposts for business decisions in 2009. Kochhar also expected a "wait and see" in the markets, although she attributed this to the state and upcoming national elections. She said that companies are hesitating to undertake expansion because there is no policy clarity right now.

¶12. (SBU) Morgan Stanley's Desai also stated that the business community was unsure about how elections would shape the business environment. He said this was not because of hesitancy if either the BJP or Congress end up at the helm, but because of concern that

the Left parties would come back in a coalition government, which he calculated as a 50% chance of happening. Desai anticipates four "equally probable" electoral outcomes: the UPA wins with the Left, the BJP-led NDA coalition comes to power, the UPA comes in with Mayawati and the BSP, or a "Third Front" is formed of the Left parties with Mayawati. Overall, though, Desai said he tells potential investors that foreign direct investment is still a good option and even more affordable now as Indian companies realize their valuations must come down. Ajay Shah, Senior Fellow at the National Institute of Public Finance and Policy echoed the effect of the Indian election cycle on investment and business decisions. He suggested that if the elections came out with a bad outcome (which he defined as a weak coalition/non standard coalition/hung parliament), which he put at a 30% probability, then it could have a detrimental impact on the economic policy framework and financial markets. He was of the opinion that investments would be postponed until election results were out and there was a clear cut policy framework in place.

COMMENT

¶13. (SBU) Mumbai interlocutors expect businesses and banks to wait a few months for clearer signs of the extent of the impact of the global economic slowdown on India (more septel). This inclination seems bolstered by a sense of political uncertainty cast by ongoing state elections, which could signal whether national elections will be held early and how different parties will fare. This feeling of political uncertainty is likely to last until after national elections, to be held by no later than May 2009. In the meantime, since local economists are not clear how much the current signs of slowdown stem from a decline in demand and how much from lack of financing, a lending paralysis could exacerbate an otherwise modest situation. However, there are signs of improving liquidity in the system, as the RBI has undertaken more than a dozen policy measures since mid-September. Even more importantly, the central bank still holds more policy tools in the CRR and repo rate to get banks lending again. We expect the RBI to deploy them in the weeks ahead.

WHITE